Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Garrick	Analyst:	Nicole Kwon	Bill Number:	AB 989
Related Bills:	See Legislative History	Telephone:	845-7800	Amended Date:	April 10, 2007
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Health Savings Account Contributions Credit

SUMMARY

This bill would create a tax credit for contributions made to a Health Savings Account.

SUMMARY OF AMENDMENTS

The April 10, 2007, amendments struck the previous provisions relating to natural heritage preservation and child care startup expense credit and replaced them with the provision to allow a credit for contributions made to a Health Savings Account (HSA).

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to allow an additional tax benefit for taxpayers that make contributions to an HSA, thus providing tax relief to those taxpayers.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment, but expressly operative for taxable years beginning on or after January 1, 2008, and ending on or before January 1, 2018.

POSITION

Pending.

ANALYSIS

FEDERAL LAW

Under federal law, individuals with a high deductible health plan (HDHP) that have no other health plan, other than a plan that provides certain permitted coverage, may establish an HSA. In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.

Board Position:			Department Director	Date
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Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual in determining adjusted gross income (i.e. "above-the-line"). Contributions to an HSA are excludable from income and employment taxes if made by the employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10%. The 10% additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

The maximum aggregate annual contribution that can be made to an HSA is the lesser of: (1) 100% of the annual deductible under the HDHP,[1] or (2) $2,850 in the case of self-only coverage and $5,650 in the case of family coverage for 2007.[2] Contributions in excess of the maximum contribution amount are generally subject to a 6% excise tax. In addition, income attributable to an excess contribution is includible in gross income in the year in which it is distributed.

Tax Relief and Health Care Act (TRHCA) of 2006 (Public Law 109-432), enacted December 20, 2006

Starting in 2007, the TRHCA made the following six changes to HSAs:

1. <u>FSA and HRA Terminations to Fund HSAs</u>

   Certain amounts in health flexible spending arrangements (FSAs) and health reimbursement accounts (HRAs) are allowed to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of: (1) the balance in the health FSA or HRA as of September 21, 2006, or (2) the balance in the health FSA or HRA as of the date of the distribution.

2. <u>Repeal of Annual Deductible Limitation on HSA Contributions</u>

   Limits on the annual deductible contributions that can be made to an HSA are modified so that the maximum deductible contribution is not limited to the annual deductible under the HDHP. Thus, starting in 2007, the maximum aggregate annual contribution that can be made to an HSA is $2,850 (for 2007) in the case of self-only coverage and $5,650 (for 2007) in the case of family coverage.

3. <u>Modification of Cost-of-Living Adjustment</u>

   In the case of adjustments made for any taxable year beginning after 2007, the Consumer Price Index for a calendar year is determined as of the close of the 12-month period ending on March 31 of the calendar year (rather than August 31 as under present law) for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (i.e., the contribution limits and the high-deductible health plan requirements).

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[1] The limits are indexed for inflation. For 2006, a high deductible plan is a health plan that has a deductible that is at least $1,050 for self-only coverage or $2,100 for family coverage and that has an out-of-pocket expense limit that is no more than $5,250 in the case of self-only coverage and $10,500 in the case of family coverage.

[2] These amounts are indexed for inflation.

4. Contribution Limitation Not Reduced for Part-Year Coverage

   In general, starting in 2007, individuals who become covered under a high deductible plan in a month other than January are allowed to make the full deductible HSA contribution for the year rather than, as under prior law, being required to prorate the deduction based on the number of months the individual was enrolled in an HDHP.

5. Exception to Requirement for Employers to Make Comparable HSA Contributions

   Enacts an exception to the comparable contribution requirements to allow employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. For example, an employer is permitted to make a $1,000 contribution to the HSA of each nonhighly compensated employee for a year without making contributions to the HSA of each highly compensated employee.

6. One-Time Distribution from Individual Retirement Plans to Fund HSAs

   Allows a one-time contribution to an HSA of amounts distributed from an individual retirement arrangement (IRA). The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under these rules are not includible in income to the extent that the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 10% additional tax on early distributions.

STATE LAW

California has not conformed to any of the federal HSA provisions. The California personal income tax return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. Adjustments relating to HSAs are required under current law, as follows:

- A taxpayer taking an HSA deduction on the federal personal income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer's California return.
- Any contribution to an HSA, including salary reduction contributions made through a cafeteria plan, made on the employee's behalf by their employer is added to AGI on the employee's California return.

Although California has not conformed to HSAs, California law is conformed to the federal rules for Archer medical savings accounts (MSAs) and allows a deduction equal to the amount deducted on the federal return for the same taxable year. California imposes a 10% additional tax rather than the 15% additional federal tax on distributions from an MSA not used for qualified medical expenses.

Because a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to AGI on the taxpayer's California return and as that MSA distribution is not treated as being made for qualified medical expenses it would, therefore, be subject to the MSA 10% additional tax.

Additionally, a federal tax-free qualified HSA funding distribution is not allowed under California law because California specifically does not conform to Internal Revenue Code (IRC) section 223, relating to HSAs, even though California conforms to IRC section 408, relating to IRAs.
Under California law, any distribution from an IRA to an HSA must be added to AGI on the taxpayer's California return and would be subject to a 2 ½% additional tax under the rules for premature distributions under IRC section 72.

THIS BILL

This bill would provide, for each taxable year beginning on or after January 1, 2008, and before January 1, 2018, a credit equal to the amount contributed by a taxpayer during the taxable year to an HSA.

This bill would specify that the credit for the contributions made to an HSA be elected by the taxpayer on the original return; this election would be irrevocable.

For taxpayers filing a joint return, this bill would specifically prevent one spouse from claiming a credit and the other claiming a deduction for the same HSA contribution.

This bill would provide a carryover provision for unused credits for eight years.

This bill contains contingency enactment language specifying that both this bill and AB 84 (Nakanishi, 2007/2008) need to be enacted and become effective on or after January 1, 2007, in order for this bill's provisions to become operative.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve this concern and other concerns that may be identified.

On page 23, line 13, and page 3, line 9, the phrase "original return for the taxable year" is unclear. The author's office may want to specify that "original return for the taxable year" must be timely filed to avoid possible disputes between the department and taxpayers.

LEGISLATIVE HISTORY

AB 84 (Nakanishi, 2007/2008), AB 142 (Plescia, 2007/2008), AB 245 (DeVore, 2007/2008), and SB 25 (Maldonado and Runner, 2007/2008) would allow the same deduction on California personal income tax returns for contributions to an HSA as is allowed on the federal personal income tax return for the taxable year. AB 84, AB 142, and AB 245 are currently in the Assembly Revenue & Taxation Committee. SB 25 is currently in the Senate Revenue & Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* does not impose a personal income tax so a comparison is irrelevant. *Illinois, Massachusetts, Michigan, Minnesota,* and *New York* conform to the federal deduction for contributions to HSAs; these states do not offer a credit for contributions to HSAs.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 989 As Amended 4/10/07 ($ in Millions)		
2007-08	2008-09	2009-10
-$20	-$130	-$210

Estimates assume enactment after June 30, 2007. This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact of the bill would be determined by the amount of contributions to HSAs and the amount of credits that could be applied to reduce tax liabilities. Estimates assume excess contributions would not be eligible for the proposed credit.

Sources of contributions to HSAs are from individuals or employers or the result of a rollover contribution of Archer Medical Saving Account (MSA) funds. Additionally the TRHCA of 2006 added a one-time rollover contribution of HRA and health FSA funds.

For the 2004 taxable year, individual tax return data indicates 7,500 returns reflected HSA adjustments on Schedule CA of the personal income tax return (Form 540) totaling $20 million. Therefore, these taxpayers made tax-deductible contributions for federal purposes that were reversed for state purposes. Recent articles indicate the number of HSAs nationwide doubled during 2005 and again in 2006. To estimate the amount of contributions in 2008 and later, this substantial growth rate is used through 2007 and is decreased thereafter to more sustainable rates. For 2008, contributions by California individual taxpayers to HSAs are estimated at $235 million.

Contributions made by an employer on behalf of an employee (including salary reduction contributions made through an IRC section 125 cafeteria plan) cannot be identified on a tax return. It is not known how many additional HSAs may exist as a result of this contribution arrangement. Data indicate that 6% of employers offer HSA-eligible HDHPs. It is believed that most of these employers pay the premium for the HDHP rather than contribute to the employee's HSA. The logic is that the premium is often less than the amount of the deductible that can be contributed to the HSA. In addition, HSA balances are portable and not owned by the employer. For purposes of an estimate, it is assumed that employer contributions on behalf of an employee are roughly one-quarter of that by individuals, or $59 million in 2008 ($235 million x 25% = $59 million).

The following is the estimate for the potential rollover contribution of Archer MSA funds. For the 2002 taxable year, tax return data indicate deductible MSA contributions totaling $11.6 million reported on 4,600 returns. It is possible that some MSA funds have already been rolled over. In addition, there is no requirement that funds have to be rolled over. It is assumed that half of these accounts (2,300) would be rolled over and each account has an average balance of $6,250. This balance equates to two-and-a-half years of average contributions (2.5 years x $2,500 average annual contribution = $6,250). Rollover contributions would total approximately $14 million (2,300 MSA accounts x $6,250 average balance = $14 million). It is anticipated that rollovers would likely occur in the initial first or second year of enactment. The rollover contributions of $14 million are divided between 2008 and 2009, or $7 million each year.

For expanded HSA provisions included in the TRHCA of 2006, estimates are based on a proration of federal estimates. Converting federal cash flow estimates to taxable year estimates indicates a revenue loss of $55 million in 2008. Dividing the federal revenue loss of $55 million by an average federal tax rate of 25% results in additional contributions totaling $218 million ($55 million ÷ 25%). The amount of federal adjusted gross income indicated on California resident returns is about 13.7% of that reported nationally. Multiplying contributions of $218 million by 13.7% results in additional contributions of $30 million for California purposes ($218 million x 13.7% = $30 million).

For state purposes, estimated contributions total approximately $330 million ($235 million from contributions by California individual taxpayers + $59 million from employers contributions for employees + $7 million for MSA rollover contributions + $30 million from TRHCA adjustment = $331 million). As the proposed credit is equal to the amount of contributions, 100%, potential credits generated total $330 million. For 2008, this amount is reduced 10% to account for some taxpayers either not making the election or not reporting the credit for one reason or another. Of the remaining credits generated, it is assumed about one-third would be applied in the year generated, $100 million in 2008. Unapplied credits would be carried over and are assumed applied over the succeeding seven-years. The proposed credit would substantially reduce or completely eliminate tax liabilities of most taxpayers contributing. Tax year estimates are converted to cash flow fiscal year estimates.

POLICY CONSIDERATIONS

1. Even though this bill would specifically prevent one spouse from claiming a credit and the other claiming a deduction for the same HSA contribution on the jointly filed tax return, in circumstance other than jointly filed returns, taxpayers can claim both the credit and the deduction for the contributions made to an HSA.
2. Generally, credits are limited as a percentage of amounts paid or incurred. This bill would allow a 100% credit, which is unprecedented.
3. This bill does not limit the amount of the credit that may be taken. Credits that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis, or alternatively on the basis of total credits for the entire year for all taxpayers.

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